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The next big thing?

Indonesia and Vietnam are rich in oil and gas, have rising populations and rapidly growing domestic demand. Ignore them at your peril, advises *Amy Auster*, Head of International Economics at ANZ Bank.

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Despite claims in the daily press over the past decade of Australia's growing economic interdependence with Asia, the reality is that corporate Australia has been asleep at the wheel. While East Asia takes 42 per cent of our trade in goods and services, thanks mostly to Japan and China, and services with East Asia are exploding (150,000 Asian students study here and more than 2 million tourists visited Australia last year and counting), East Asia only receives 10 per cent of our cross-border private sector investment. Meanwhile, the United States and the United Kingdom receive 25 per cent and the European Union gets more than 30 per cent.

Frankly this is surprising considering East Asia's strong growth, both present and past. Since 2000, real annual gross domestic product (GDP) growth in East Asia, excluding Japan, has averaged 8.0 per cent against 2.3 per cent for the G7 economies and 2.4 per cent in Australia. Annual business investment and industrial production has averaged more than 10 per cent for the past four years, versus less than 4 per cent for the G7.

Moreover, economic growth in Asia is not all about exports. Domestic Asian consumption has risen by 3.2 per cent per annum over the past five years, against 2.2 per cent per annum in Europe and 3.1 per cent in North America. The obvious implication is that Asia is fast becoming an important source of global demand – which is not surprising considering it is home to 40 per cent of humanity.

There are signs, however, that Australian companies are starting to lift their game. Australian investment into Asia rose from only $2.6bn in 2004 and $3.9bn in 2005 to a much stronger $21.1bn last year. Still, there is a long way to go. Australian businesses looking to grow into Asia usually opt for a China strategy, but an increasingly challenging and expensive operating environment and crowded marketplace has meant that businesses are asking the question: What other options are out there?

After China, Indonesia and Vietnam have the largest populations in East Asia. Both are endowed with natural minerals resources and have established manufacturing sectors and both need significant infrastructure investment to support a rapidly growing domestic demand. From an Australian company's point of view, the political and economic ties that Australia has shared with these two countries provide brand-name recognition that may be lacking elsewhere. In other words, Indonesia and Vietnam may be the next big thing for Australian firms.

GO FOR GROWTH

After China, Indonesia and Vietnam boast some of the Asia Pacific region's highest growth rates. This year, real GDP is expected to expand by 6.0 per cent in Indonesia and 8.5 per cent in Vietnam, with similar rates projected for 2008 and 2009. However, the factors driving growth in Indonesia and Vietnam are quite different.

Indonesia is essentially making up for lost time following the 1997-1998 financial crisis. The political upheaval and transition to democracy that followed contributed to a tremendous economic setback, and it was only in 2005 that personal incomes and asset prices returned to pre-crisis levels.

In recent years, Indonesia's rising growth rate has been fuelled by classic reform that has brought Indonesia close to an OECD-style economic policy framework. The government's fiscal accounts are vastly improved, and the stock of public sector debt has declined from more than 100 per cent of GDP in the aftermath of the crisis to less than 40 per cent today. Falling government debt levels are 'uncrowding' the financial system and freeing up funds for private investment.

This reduction in debt has been accomplished while the government restructures the banking system, with the largest 15 banks now reporting a non-performing loan (NPL) ratio below 8 per cent and a liquidity ratio in excess of 100 per cent. The Central Bank has fully floated the currency and moved to an inflation-targeting framework, which will produce stable interest rates in a low inflation environment over the medium term. In fact, the Indonesian rupiah is arguably one of the only truly floating currencies in the region.

As with the Australian experience with the float of the A$ in the mid-1980s, the float of Indonesia's currency combined with financial sector reform provides an important market-driven buffer to external changes. In this vastly improved economic environment, Indonesia will be able to sustain its long-term potential rate of economic growth, estimated by ANZ Bank to be around 6 per cent per annum. If the forecasts prove correct, the size of Indonesia's economy will expand from US$960bn at present to more than US$2 trillion by 2020, raising Indonesia from the 15th largest economy in the world to within the top 10 over that period.

In contrast, Vietnam's high growth rate is the result of an initial process of economic opening and industrialisation, started across East Asia more than 20 years ago. The process of industrialisation is clear, with agricultural production down from 30 per cent of GDP in 1990 to 20 per cent today. Meanwhile, industrial production rose from 25 per cent of GDP in 1990 to 40 per cent now. The process of industrialisation has been driven by the reform of the state-owned sector, which has seen a considerable decline in the number of state-owned enterprises – from more than 12,000 in 1990 to less than 4,000 today. Another contributing factor has been the opening of the economy to external trade. Exports now account for more than 60 per cent of GDP in Vietnam against 45 per cent of GDP just five years ago. Of that, foreign-invested firms are responsible for the production of roughly half of Vietnam's exports.

Vietnam has become an alternative manufacturing base to southern China, with more than 60 per cent of foreign direct investment (FDI) in the manufacturing sector having originated in Taiwan, Korea

DEVELOPING COUNTRIES

Poverty and deficits linger

Structural adjustment programs (SAPs) are conditional policy changes implemented by the World Bank and the International Monetary Fund in developing countries to reduce a country's fiscal imbalances. They reduce the role of government and focus on macroeconomic reforms such as promoting free trade and deregulating financial, legal and regulatory frameworks.

The policies of SAPs typically constitute a phase of 'stabilisation'. These policies can include a 0–1 per cent budget deficit, control of inflation, a new competitive exchange rate through devaluation and equilibrated balance of payment and a phase of 'structural change' that includes liberalisation of trade and capital flows, privatisation of public industrial and service enterprises and financial and administrative reforms to introduce market forces in the public and Japan. Intel, Nike and Canon have set up there, and FDI has risen from 25 per cent of GDP in 1990 to 66 per cent today, with the bulk going into the manufacturing sector.

Vietnam's entry into the World Trade Organisation (WTO) in late 2006 is expected to provide a further impetus for growth, not just in terms of opening export markets, but also because of the ongoing deregulation of the local market. For example, before last year, foreign companies were not allowed to participate in distribution to the retail market in Vietnam and, as a result, there were no foreign franchise outlets to be seen in Vietnam's major cities. Meanwhile, more than 70 per cent of households avoid bank loans to finance a motorbike or build their homes and rely instead on family or friends. The opening up of these new markets to foreign firms and the infrastructure required to support these activities will drive Vietnams' economy towards rates in the vicinity of 7-8 per cent per annum over the next five years.

THE YOUNG ONES

Indonesia and Vietnam's demographics compare favourably to China's. Indonesia has 222 million people and Vietnam 84 million. By 2015, Indonesia is expected to have a population of 251 million and Vietnam 96 million.

The populations are large and young. Comparing countries by median age of the general population, Indonesia ranks 83rd (median age 26.5) and Vietnam ranks 95th (median age 24.9), far younger than China which ranks 57th (32.6 years) and Australia in 36th place (36.6 years). The demographics have implications for consumer behaviour in the future, as a lower dependence ratio in Indonesia and Vietnam means that the younger segments of the population will be under less pressure to support their elderly relatives. In contrast, the savings rate is expected to remain high in China until a social safety net is secured.

Well-educated, dynamic and fun to be around

sector. Although SAPs have successfully opened many economies by eliminating excessive and inefficient state control, they have mostly failed to control fiscal deficits and, more importantly, to alleviate poverty. Launched in 1997 with the consent of the World Bank, the Structural Adjustment Program Review Initiative Network (SAPRIN) investigated the impact of SAPs in eight countries: Bangladesh, Ghana, Uganda, El Salvador, Mali, Zimbabwe, Ecuador and Hungary. It found that structural adjustment measures have significantly increased poverty, inequality and social exclusion. Meanwhile, a study of Sub-Saharan Africa (SSA) found that even after three decades of SAPs, 'sustainable economic and market viability is yet to be restored in any single country'.

So what went wrong?

GOOD GOVERNANCE

The most common elements of good governance include political accountability, a sound judicial system, accountability and transparency and, most importantly, incorporation of market principles in the operation of public organisations. Good governance needs a high level of cooperation and collaboration between sectors to ensure synergetic relationships and lower governance transaction costs.

A World Bank-commissioned study from 2003 identified a set of governance indicators covering almost 200 countries for the period 1996-2002. It focuses on six dimensions: voice and accountability, political stability and absence of violence, government effectiveness, regulatory quality, rule of law and control of corruption. These indicators are closely interlinked and it is reported that adherence to any of the six indicators causes a two-and-a-half-fold increase in per capita income, a four-fold decrease in infant mortality and a 15-25 per cent increase in literacy. The establishment of good governance – critical for the successful outcomes of the reforms – therefore remains as a great challenge for both International Financial Agencies (IFAs) and third world countries.

CONDITIONALITY AND POLICY OWNERSHIP

Aid conditionality has been used by the financial agencies as a popular instrument to promote policy reforms in third world countries. However, so far this

Although China has a much larger population, only 40 per cent of the population lives in urban areas against 48 per cent in Indonesia. Vietnam has a lot further to go on urbanisation but the process also implies opportunities for infrastructure development in the major urban centres around Hanoi and Ho Chi Minh City.

RESOURCE RICH

Both Vietnam and Indonesia are believed to have substantial oil and gas resources. Both export oil at the moment but are net importers of petroleum products due to a lack of domestic refining capacity. Indonesia has been aggressively developing its gas industry with an eye toward exporting liquefied natural gas through the region. Coal is one of the largest areas of industrial production in Vietnam, with strong growth also recorded in natural gas in recent years.

Indonesia and Vietnam also have substantial manufacturing bases that are viewed as globally competitive due to lower labour and land costs. While labour is arguably not as productive as in China, Indonesia and Vietnam are viewed as good alternatives to an increasingly expensive China. Their geographic location and multiple domestic ports – while still lacking world class infrastructure – make both countries well-suited for production for export markets.

In Indonesia, the up-and-coming sectors as judged by domestic investment flows are paper products manufacturing, chemicals and pharmaceuticals production and food processing and production. Foreign investment has lagged the domestic action. It has been a tiny fraction of domestic investment with a paltry US$3.7bn invested in the first half of this year. In Vietnam, from a production-for-export perspective, textiles and footwear has been a key focus, particularly as China's response to rising trade tensions with the US has been to tighten regulations that supported cheap manufacturing of these goods in China.

Finally, domestic demand for services in both countries is growing strongly. Vietnam literally cannot find enough professionals, whether it's in the legal, accounting or financial field. The take-off in both countries of Information and Communication Technology (ICT) and popular media provides huge opportunities as well. Going forward, the strong reputation of Australian firms in tertiary education and health care position them well to provide these services in the rapidly growing markets of Indonesia and Vietnam.

conditionality has not delivered the desired rates of compliance among the loan recipient countries. Despite the expansion of its use since the 1980s, conditionality is being questioned as ineffective, intrusive and corrosive. The problem with it lies in the actual ownership of the program. Put simply, country ownership of programs is essential as this not only generates a firm commitment from the national government, but it also increases the probability that programs will succeed and that money and resources provided will be used properly.

STAKEHOLDER INVOLVEMENT

Agreements on implementation of programs reached in non-transparent discussions between small groups of national government officials and the World Bank is a top down approach that can exclude important stakeholders such as local governments. Realising the importance of the involvement of stakeholders, Poverty Reduction Strategy Papers (PRSPs) now place a strong emphasis on making policies inclusive of all stakeholders. Reform policies promoted by the IFAs in third world countries have not been able to achieve their expected benefits in most of the cases. Realising the failure of the policies, the IFAs have considerably changed both their policy response and philosophy regarding third world countries. PRSPs have now become the basis for all debts/loans provided by the IFAs and are expected to be country-owned and involve the participation of all stakeholders.

There has been much attention about the importance of promoting good governance in third world countries but, in reality, the issues of good governance, stakeholder involvement and country ownership have not been addressed adequately. As a result, despite all the rescheduling and restructuring, economic development in third world countries remains elusive.

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ADDRESSING BUREAUCRACY

Perhaps the biggest difference in the operating environment between Vietnam and Indonesia is in government. While Indonesia has transitioned to a multi-party democracy, Vietnam is a one-party state. The Vietnamese government does work to attract large investors by providing certainty around operational issues such as licensing approvals and tax exemptions and it has funded the joint development of industrial parks for foreign firms.

Such incentives are more difficult to find in Indonesia, which is a more mature economy and where the pressures of public opinion can get in the way of well-laid government plans. Companies doing business there complain about entrenched corruption in the bureaucracy, a problem that the government readily acknowledges and is actively trying to address, as well as difficulties in dealing with government officials at the local, provincial and national level. A complex legal system dominated by Dutch law with sometimes unpredictable court decisions also cause unforseen hiccups, while security concerns add another layer of complication.

At the same time, if the quality of a management team is a good indicator of the future performance of a company, Indonesia's political leadership under President Susilo Bambang Yudhoyono bodes well for the future. The economic team is led by US-educated Finance Minister Sri Mulyani Indrawati and the respected Coordinating Minister for Economic Affairs Dr Boediono. The team has implemented a raft of important reforms covering foreign investment, the development of the domestic funds management industry and financial markets and the tax regime, among other things. This government has two more years left in its term and at this stage is expected to be re-elected in 2009. If so, further deep and long-lasting reform is expected to bring about a vastly improved operating environment for foreign and domestic firms.

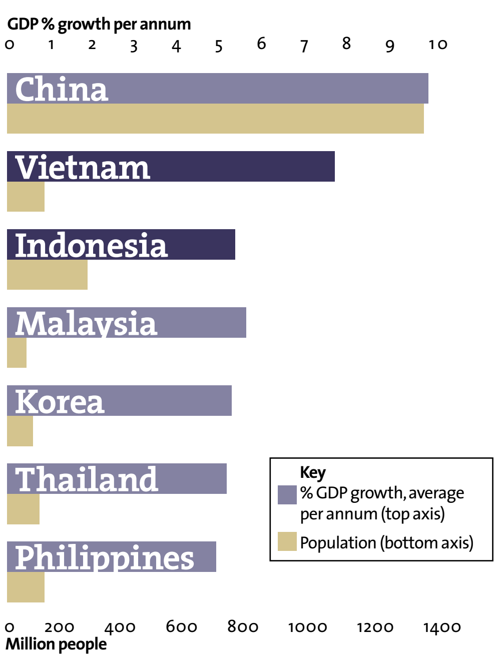
FUTURE RISKS

While there are certain to be opportunities for Australian companies in Indonesia and Vietnam in the future, these environments are not without risks. Both countries are rated by major credit rating agencies Moody's and S&P to be in the "BB" territory, one step below what is considered investment-grade.

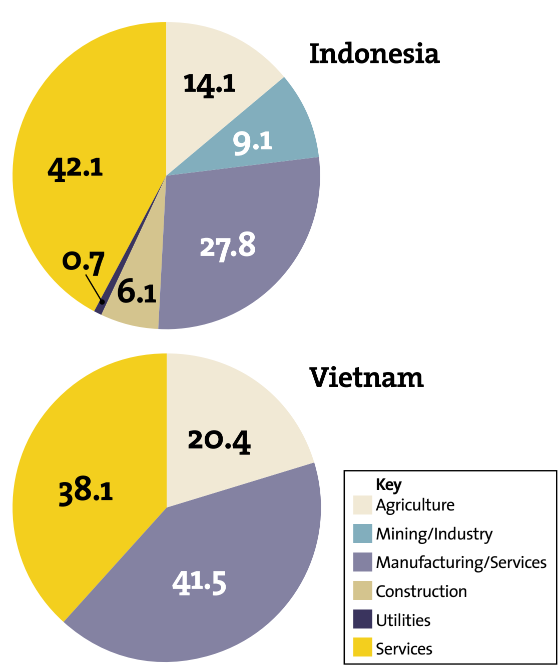
From a macro-economic point of view, Indonesia's reform process has strengthened the fundamentals

Indonesia and Vietnam: Large populations, high growth rates

Source: Datastream, Economics @ ANZ



Indonesia's economy more mature than Vietnam's



Enjoys spending quality time with professionals and forward-thinkers

of the economy such that Indonesia's credit rating is likely to improve over the medium-term. The economy is transparent and data on key indicators is regularly published and widely available. The reduction in public sector debt, recapitalisation of the banking system and continued withdrawal of the state from commercial activity all bodes well for the strength of Indonesia's economy in the future.

The probability of a nasty, systemic surprise emanating from an under-capitalised, poorly regulated banking system, or of the economy being caught unawares by a sudden movement in the exchange rate, is remote.

In contrast, Vietnam is only beginning down the path to a market-driven economy. Government debt has been rising and is now more than 45 per cent of GDP according to the International Monetary Fund, with the government consistently running fiscal deficits off a narrow tax base. The exchange rate is stable, but is heavily managed by the State Bank of Vietnam which is not independent of the government.

As such, the development of monetary policy is in an immature state, leaving greater risks in the future around the volatility of the exchange rate and interest rates. The majority of the banking system is still state-owned and important economic data, such as the level of foreign exchange reserves held at the central bank, are not regularly reported.

So, while Vietnam's economic prospects are good, the risk of an economic disruption in relation to this reform process is greater than in Indonesia over a medium-term horizon.

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Indonesia is more wealthy, but Vietnam is rising fast

Source: Datastream, Economics @ ANZ